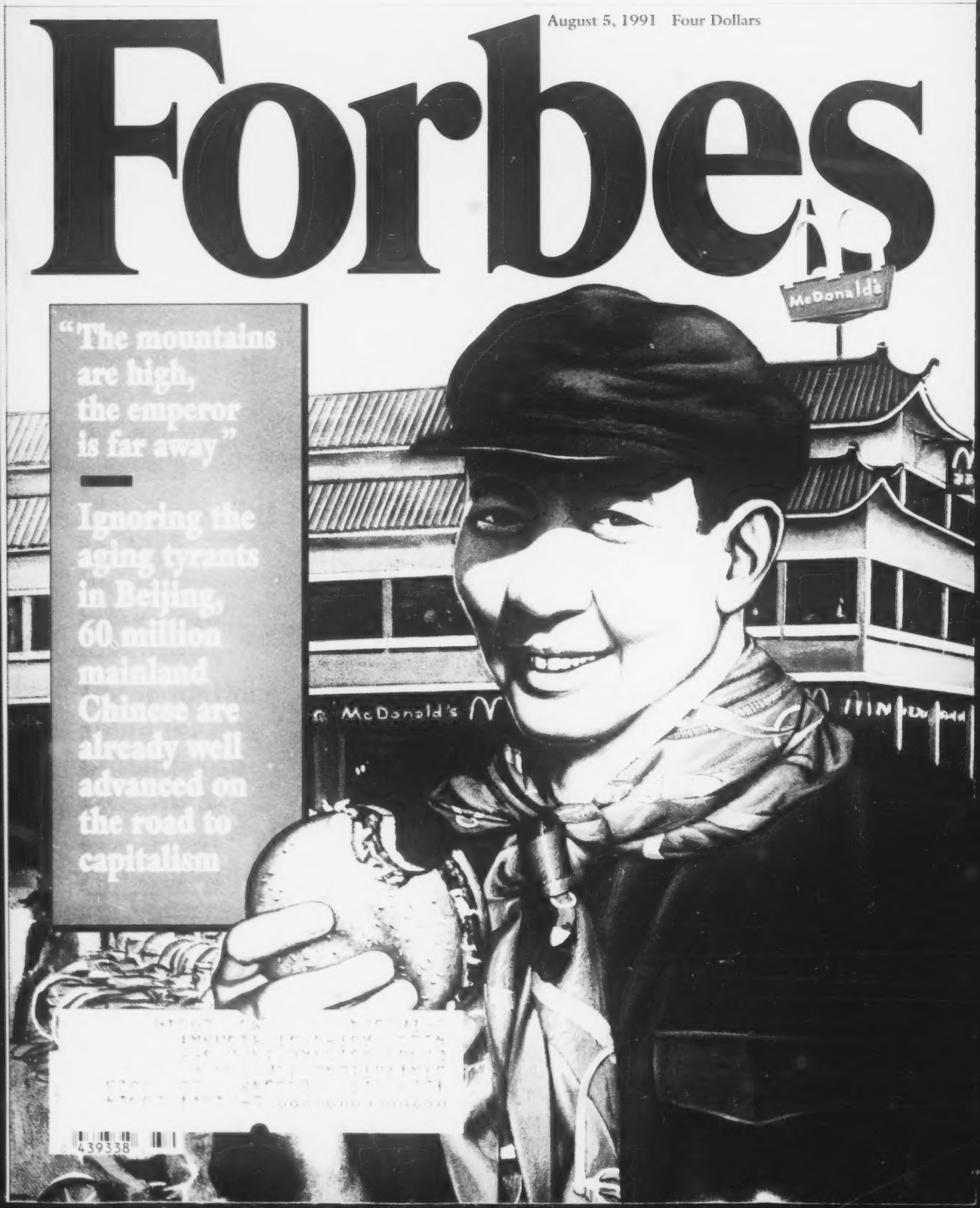
August 5, 1991 Four Dollars

Forbes



"The mountains are high, the emperor is far away"

—

Ignoring the aging tyrants in Beijing, 60 million mainland Chinese are already well advanced on the road to capitalism

439338

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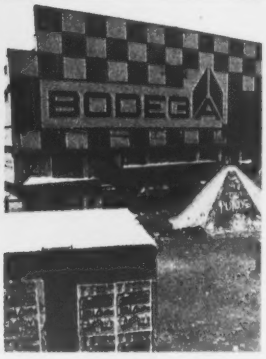

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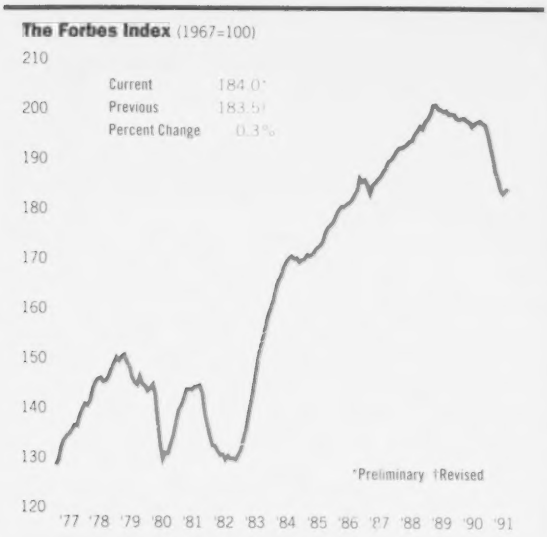
THE FORBES INDEX

BY TIMOTHY DODMAN



How solid is the recovery? Recent data give conflicting signals. Auto sales rose 1.1% in June, but showroom activity was not strong enough to pull up the entire retail sector. Overall June retail sales were off 0.2% following a downward revision in the May total. Meanwhile, strength appears to be developing in the manufacturing sector. Industrial production posted its third consecutive monthly gain, with a 0.7% increase in June. And U.S. mines, factories and utilities operated at 79.3% of total capacity—the highest level since January.

Other key rates	Source	Status
Prime rate	Chase Manhattan Bank	8.5%
Auto sales year to date vs 1990[1]	Ward's Automotive	-12.7%
Index of leading indicators May vs Apr	Dept of Commerce	0.8%
Trade balance 12 months ended Apr 1991	Dept of Commerce	-$89 bil
All-commodity producer price index June vs May[2]	Dept of Labor	-0.2%
GNP 1st quarter vs. 4th—annualized growth	Dept of Commerce	-2.8%
NBER Experimental Recession Probability Index[3]	Natl Bureau of Economic Research	1.0%

[1] U.S.-based manufacturers, excludes imports, as of 6/30/91. [2] Wholesale goods. [3] May 1991.

Index components

The Forbes Index is a measure of U.S. economic activity composed of 8 equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, new housing starts, total retail sales, the level of new orders for durable goods compared with manufacturers' inventories, personal income, total consumer installment credit.

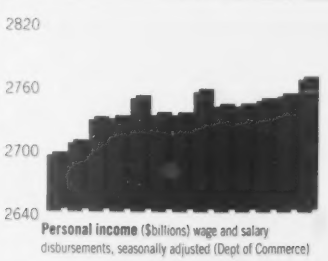
To measure these 8 elements, FORBES monitors 10 series of U.S. government data. The last 14 months' data for each series are presented below.

Consumer price indexes (1982-84 average=100) all urban consumers, unadjusted (Dept of Labor)

Manufacturers' new orders and inventories ($billions), seasonally adjusted (Dept of Commerce)

Industrial production index (1987=100) seasonally adjusted (Federal Reserve)

New housing starts (thousands) privately owned, unadjusted (Dept of Commerce)



Personal income ($billions) wage and salary disbursements, seasonally adjusted (Dept of Commerce)

New unemployment claims average for month (thousands), seasonally adjusted (Dept of Labor)

Retail sales ($billions), seasonally adjusted (Dept of Commerce)

Consumer installment credit ($billions) total, seasonally adjusted (Federal Reserve)

M J J A S O N D J F M A M J

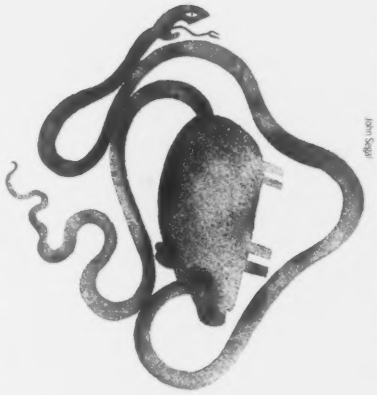
M J J A S O N D J F M A M J

M J J A S O N D J F M A M J

As quick cures for banking's woes, mergers don't work. They take time, skill and luck—as shareholders will discover when the proposed Manufacturers/Chemical "merger of equals" goes through.

Dangerous medicine

By Tatiana Pouschine



A LOT OF PEOPLE think mergers are the cure for what ails the nation's banks. The boards of Manufacturers Hanover and Chemical Banking are apparently among the believers, having just announced their intention to combine the two money center banks. The believers are not a lonely group. In late June Wachovia Corp. announced an agreement to purchase South Carolina National Corp. for $835 million in stock. At about the same time, NCNB began merger discussions with Virginia-based C&S/Sovran. In April Fleet/Norstar and Kohlberg Kravis Roberts took over the Bank of New England's assets. Rumors continue to swirl around other big banks.

In theory, bank mergers diversify assets, increase market share and allow for economies of scale. That's in theory. In practice, the road to merger is strewn with roadblocks and wreckage. Bad loans suddenly surface in the pool of acquired assets. Economies of scale often prove illusory or very expensive.

The proposed Chemical/Manufacturers combine will put the merger theory to one of its toughest tests. With duplicate branches throughout the New York metropolitan area, the expanded Chemical Banking will have to close 80 New York branches. It will have to mesh different computer systems and manage the expense of eliminating 6,200 positions. While doing all this, the merged bank's management will have to be careful that customers, annoyed at the upheaval, don't depart to rival banks.

The planned merger of Manufacturers and Chemical has avoided one problem that has plagued bank mergers: Expectation of merger savings is often built into the price paid by the acquiring bank. By treating this merger as a pooling and basing the share exchange on relative market prices, the Chemical/Manufacturers merger plan avoids giving shareholders of either bank a premium over book value. Such premiums have proved costly to acquiring banks.

From 1985 to the present, banks have paid on average 1.5 to 2 times book value to acquire other banks, basing the premium over book on the expected savings and on the supposed value of the acquired franchise.

But can a bank really be worth much more than book value? Some skeptical investors doubt it. After all, loans are never paid off at more than 100 cents on the dollar and are often paid off at much less. As for the value of the franchise, this has been greatly lessened by the increase in competition from outside the traditional banking system: commercial paper and money market mutual funds and outfits like GE Credit, Sears and Ford Motor Credit.

While avoiding the problem of paying a premium, the Chemical/Manufacturers proposal raises another question: Are the banks in equally sound condition? The merger terms assume they are, since the distribution of stock between shareholders of the two banks is in rough approximation to the common equity capital each is contributing. But some analysts think Manufacturers has not recognized bad debts as assiduously as Chemical has. For example, Manufacturers has a $4.4 billion exposure in loans to less-developed countries against which it has reserved 51%. Chemical has reserved 77% against a less-developed-country loan total one-third the size of Manufacturers'. On loans for highly leveraged takeovers, Manufacturers has reported a 13% nonperformance rate, while Chemical's nonperformance rate on these loans is only 5%. This much is undeniable: On the day the merger was announced, Manufacturers' shares jumped twice as much as Chemical's, suggesting that the market felt Manufacturers was getting a good deal.

All this is not to say that bank mergers are no good. Wells Fargo's purchase of the Crocker bank for $1.1 billion in 1986 worked out beautifully. Why? Because the price was right: Carl Reichardt, Wells Fargo's chief executive, acquired Crocker for close to net asset value. He then cut costs ruthlessly. Wells Fargo's noninterest expense, as a percentage of revenues, was 53% last year, down from 62% in 1986.

Chemical Banking Corp.'s takeover in 1987 of Texas Commerce Bancshares and its $17 billion of assets did not go so smoothly. Walter Shipley, Chemical's chief executive, paid roughly book value in a cash and stock transaction valued at $1.1 billion. That seemed cheap enough, but it was probably too high. In less than two years Texas Commerce's cumulative losses mounted close to $500 million.

Chemical earned $100 million in Texas last year, but the merger is still in the red on a cumulative basis and the return on Chemical's investment after four years is zero to date.

Chemical had yet another bad ex-

Do bank acquisitions pay off?

Acquiring bank	Price/book 1985	Price/book recent	Return on assets 1985	Return on assets 1990	Overhead ratio[1] 1985	Overhead ratio[1] 1990
Money centers						
Bank of New York	1.2	0.8	0.70%	0.68%	52.8%	61.1%
Chemical Bank	0.9	0.6	0.68	0.40	62.3	73.6
Regional						
Bank One	2.4	1.2	1.20	1.40	53.0	56.0
Bank of New England	1.4	NA	0.90	NA	61.7	NA
Citizens & Southern	2.4	NA	1.03	NA	NA	NA
Sovran	1.5	NA	1.03	NA	NA	NA
C&S/Sovran[2]	NA	0.9	NA	0.45	63.4	67.3
CoreState Financial	1.4	1.7	0.87	0.48	60.6	64.6
First Union	1.5	1.0	1.05	0.75	56.7	64.5
Fleet/Norstar	1.7[3]	1.4	1.15	def	55.2	64.2
NCNB	1.9	1.3	0.83	0.56	57.8	68.2
PNC Financial	1.6	1.3	1.00	0.16	55.9	58.6
SunTrust	2.1	1.7	0.86	1.05	63.3	61.7
Wachovia	1.9	1.8	1.01	1.13	55.9	57.7
Wells Fargo	1.0	1.2	0.65	1.14	58.7	52.9
Average of acquirers	1.6	1.3	0.94	0.75		
Average: U.S. banks			0.70	0.50		
money centers	1.0	1.0				
regional	0.9	1.3				

[1]Noninterest expense as a percentage of revenues. [2]C&S merged with Sovran in 1990, forming C&S/Sovran. [3]Figure is for Fleet, prior to 1988 merger. NA: Not applicable. def: Deficit. *Sources: Standard & Poor's for average market to book value comparisons; FDIC for data on ROA comparison for U.S. bank averages.*

If the past repeats, bank acquisitions will deliver less than promised. Market multiples for the average bank have stayed even or gone up since 1985. Just before the Chemical/Manufacturers announcement, only 2 among the acquirers were trading at higher multiples than in 1985. All but 2 showed above-average returns in 1985; in 1990, 5 out of 11 operated below national averages.

perience. In May 1986 it offered to buy Horizon Bancorp, the fifth-largest bank holding company in New Jersey, for $660 million in cash. That was roughly 2½ times book. Again, Chemical got more bad loans than it had bargained for.

Chemical is not alone in experiencing painful mergers. In 1985 Trust Co. merged with Sun Bank Inc. in Florida to form SunTrust. A year later SunTrust bought Tennessee-based Third National Bank Corp. From $6 billion in 1984, the merged entity's assets jumped to $33.4 billion. Since the mergers, SunTrust's nonperforming loans rose to 3% of total loans, up from 0.83% at the end of 1986. A good portion of the problem loans are for real estate in Tennessee, the result of the third acquisition.

Many other banks have experienced the difficulty of evaluating a large pool of assets in a relatively short period of time. First Union Corp. had to charge off an unexpected $60 million in bad loans after its acquisition of First Railroad & Banking Co. of Georgia in 1986.

That's why it's so important not to overpay: Too many surprises are possible. NCNB avoided that problem when it bought the failed First Republic Banks of Texas from the FDIC, getting roughly $20 billion in assets with little risk because the FDIC agreed to swallow the bad loans.

The deal worked out well for NCNB. In 1990 it earned over $300 million on its $1.3 billion investment, but only because the government agency took roughly one-quarter, or $6 billion, of First Republic's weakest assets. Without the government bailout of First Republic, NCNB would have had to absorb $1.5 billion in losses related to First Republic between the end of 1988 and 1990.

Even then NCNB was somewhat lucky. The FDIC protection extended on the acquired portfolio to greater or lesser degrees only through 1990. If the Texas economy hadn't started to rebound late last year, it is possible that many more of those assets would have turned into problems and the government wouldn't have been there to help. This point is worth remembering for banks doing mergers in the Northeast, where a real turnaround in the economy may be many years in the future.

The danger of finding booby traps in an acquired bank's portfolio aside, those vaunted merger savings are harder to come by than a lot of people think. "Due diligence," says Standard & Poor's bank rating analyst Tanya Azarchs, "is a very tricky thing." First Republic, acquired by NCNB, was itself a product of a giant merger that was supposed to yield tremendous savings but fell short of expectations.

In the Chemical/Manufacturers deal, it is stated that the new Chemical will be able to cut $650 million a year—about $4 a share on the new stock before taxes—by cutting overhead. But this will take time—and luck: Only two banks involved in major mergers between 1985 and 1990 show improved operating productivity as measured by ratio of noninterest expenses to revenues *(see table)*.

Why? To cut costs, a bank has to buy out dismissed employees and get rid of surplus office space. Even efficiently run First Wachovia took four years to integrate First Atlanta's system into its own.

Or take First Union Corp., which more than doubled in size to $41 billion last year from $17 billion in 1985. It took First Union three years to convert First Railroad & Banking's 18 separate banks and 154 branches to one new system. In the meantime, disgruntled customers were walking their deposits out the door. At the end of 1985 First Union's noninterest expenses were running at 57% of its revenues; in 1990, when the merger was four years old, they had gone up to 65%. Savings?

Bank mergers do make good sense in a nation that has 15,000 banks, many of them competing furiously with nonbanks with far lower costs. That's why the Federal Deposit Insurance Corp. encourages them, and why the Chemical/Manufacturers union will undoubtedly receive federal blessing. But the mergers make sense only when the price is right—meaning cheap. Banks should learn from junk bond buyers. Junk bonds have been good buys recently, but only if the price is right.

Having disappointed even its most ardent fans, gold is attracting attention again. One way to play is through shares of the South African companies listed below.

Fire insurance?

By Steve Kichen and Warren Midgett

Louie Gubb/IB Pictures

Refining South African gold
"To its ultimate credit, gold is a monetary outcast. It doesn't go to the G-7 meetings."

SINCE PRESIDENT BUSH lifted sanctions against South Africa last month, Harry Schwarz, South Africa's ambassador to the U.S., reports that there has been a surge of interest in South African issues from investors in the U.S., Europe and Johannesburg. Historically, most of the interest has been focused on South Africa's big gold mining companies.

As the table shows, the shares of these mining firms and conglomerates with substantial mining interests are not particularly cheap on the basis of price/earnings ratios, but you don't buy these shares for earnings. Wesley A. Stanger Jr., chairman of ASA Ltd., the closed-end fund that specializes in gold stocks, explains: "The P/Es don't mean a darn thing. The trick is how much gold you are going to get out, and at what price."

In other words, you pay for the probable eventual value of the gold still in the ground, which is partly determined by the cost of getting it out and partly by the world price of gold. For example, Stanger points out that Stilfontein Gold Mining Co. recently shut its mine because it could no longer profitably mine gold, given the current world price ($368 an ounce) and the company's high cost of extraction. By contrast, says Stanger, the nine companies listed in the table all have adequate reserves that can be economically mined even at today's world price.

Note that some of the companies offer attractive dividend yields—a kind of payment while waiting for gold to recover. But Stanger eyes the high yields cautiously. "The better mines have lower yields, the dogs are paying out their last nickel," counsels Stanger, whose favorite South African stock is Sir Harry Oppenheimer's big Anglo American Corp. of South Africa Ltd. This holding company's yield is just 2.7%.

Gold has been a poor hedge this year, following the crisis in the Persian Gulf, and has disappointed even its staunchest supporters in recent years. But trends change when people least expect them to. James Grant, of *Grant's Interest Rate Observer*, has turned bullish on gold because it represents a haven from the excesses of the 1980s. Says Grant: "To its ultimate credit, gold is a monetary outcast. It doesn't go to the G-7 meetings."

ASA's Stanger is optimistic about the price of gold because he thinks the world is heading toward economic trouble. Says he: "We see this morning, for example, that Mutual Benefit Life has troubles. If you look around the world, you see it is on fire, and the fire is not going out."

Gold, fingered

Company	Recent price	—Estimated EPS— 1991	1992	P/E 1991 estimated	Yield
Anglo American	$37.84	$3.07	NA	12	2.7%
Anglo American Gold Inv	77.10	2.97	NA	26	3.2
Driefontein Consol	13.48	0.46	$0.49	29	4.4
Gencor	4.50	0.37	0.37	12	3.9
Johannesburg Consol	16.90	1.02	1.18	17	3.3
Kloof	11.22	0.15	0.33	75	3.2
Southvaal Holdings	34.13	1.10	1.40	31	4.0
Vaal Reefs	77.26	3.23	3.92	24	5.7
Western Deep Levels	42.18	0.92	1.19	46	3.1

NA: Not available.
Source: The International Summary of the Institutional Brokers Estimate System via Randall-Helms DataScreen II.

In an uncertain world, there's something to be said for holding some gold-related investments. These South African gold mining firms (or industrial holding companies with significant interests in gold) are producing a lot of the yellow metal.

THE FORBES/BARRA WALL STREET REVIEW

BY ERIC S. HARDY

The market may be good, but it is not cheap. The Barra All-US index of over 5,000 stocks is selling for nearly 21 times latest 12-month earnings. (Unlike some other widely published market indicators, the P/E of this index includes negative earnings.) Wall Street is obviously counting on optimistic earnings forecasts for 1992 to sustain current share prices. The Institutional Brokers Estimate System is expecting a 24% profit increase for the S&P 500 in 1992. If these projections turn out to be widely off base, it is unlikely the market will keep on flirting with new highs.

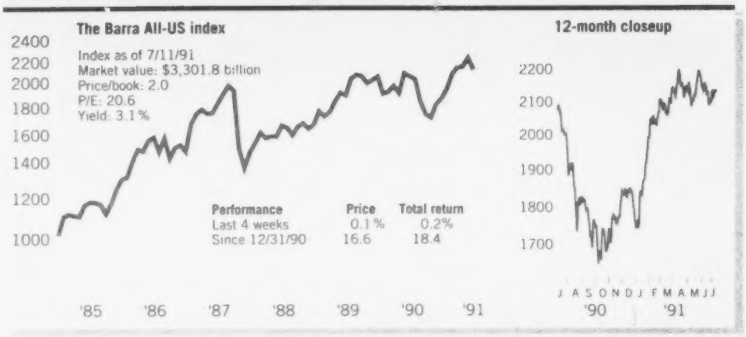
Over the last year the S&P 500 has a total return (including reinvested dividends) of 8%. But the Sharpe/Barra Growth index—big stocks with high earnings growth in the past and expected high growth in the future—has a 10% total return. In a rallying market, such growth stocks often lead the rest of the pack.

Special focus

"If the U.S. sneezes, Zimbabwe doesn't necessarily catch a cold," says Paul Melton, editor of Amsterdam-based *The Outside Analyst*. His point: performance of emerging markets is not highly correlated with developed markets. His favorites? Hong Kong and the Philippines. A recent Barra study found that a 10% inclusion of emerging market stocks in a portfolio of U.S. stocks and bonds would have increased returns and lowered risk.

Risk versus reward (1986-1991)

The overall market



Closeup on the market

Index or investment	2-week change	% change from 1 year	% change from 5-year high
Barra All-US index	1.4%	4.3%	-2.9%
Sharpe/Barra Growth index[1]	1.7	10.1	-2.2
Sharpe/Barra Value index[2]	0.2	8.1	-2.8
Dow Jones industrials	0.8	0.9	-2.5
S&P 500	0.7	4.4	-3.5
NYSE	0.8	4.8	-3.1
Nasdaq	2.5	5.3	-4.5
Amex	0.7	0.7	-3.1
EAFE[3]	-1.2	-14.8	-24.7
CRB index[4,5]	-2.0	-11.8	-24.3
Gold[5]	0.4	4.0	-26.7
Yen[5]	0.6	-6.8	-15.4
Oil[5]	-4.9	16.0	-52.6

The best and worst performing stocks[6]

Best	Price	2-week change	1991 EPS[7]	Worst	Price	2-week change	1991 EPS[7]
Ashton-Tate	16	52%	$0.52	EMC Corp	7 1/2	-27%	$0.85
Craig	20 5/8	38	1.60	Riggs National	6 1/2	-20	-0.90
Cray Computer	12 1/8	32	-2.39	HON Industries	14 3/4	-17	0.96
Cirrus Logic	20	29	1.41	First Interstate Bancorp	27 5/8	-16	3.08
Filene's Basement	23 3/4	28	0.74	New Jersey Steel	11 3/4	-16	0.18

The best and worst performing industry factors[8]

Best	2-week change	Since 12/31/90	Worst	2-week change	Since 12/31/90
Tobacco	6.5%	42.4%	Consumer durables	-4.4%	18.8%
Aerospace	4.3	16.6	Oil service	-3.1	-7.0
Business machines	3.7	17.7	Coal & uranium	-2.6	-5.4
Media	3.4	8.4	Life insurance	-2.4	13.5
Pollution control	3.3	2.8	Water transport	-2.0	13.9

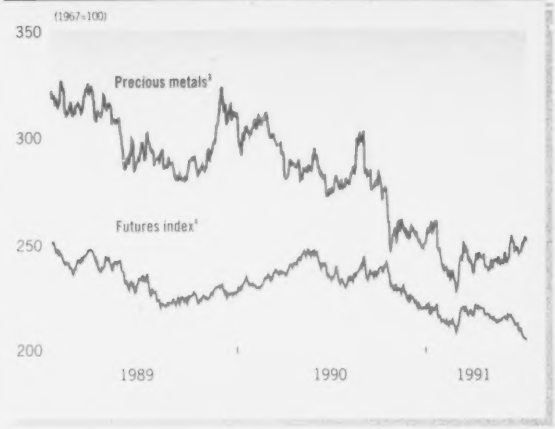
Note: Data for period ending 7/11/91. The Barra All-US index consists of all publicly traded common stocks for which price quotations are available and ordinary shares of foreign stocks trading on U.S. markets. ADRs, REITs and closed-end funds are excluded. [1] Total return of a portfolio of more than 150 large-capitalization stocks that has high historical earnings growth and has predicted above average earnings growth. [2] Total return of a portfolio of more than 300 large-capitalization stocks characterized by low price-to-book ratios, high yields and low price-to-earnings ratios. [3] A dollar-denominated capitalization-weighted index of more than 1,000 stocks from Europe, Australia, New Zealand and the Far East. Source: Morgan Stanley Capital International Perspective. [4] Index of 21 commodity futures. [5] Knight-Ridder Financial Information. [6] During the last two weeks. [7] Institutional Brokers Estimate System, from Lynch, Jones & Ryan. [8] Shows total return to the industry factor after controlling for other influences including company size, value and growth characteristics. Multi-industry firms have proportional contributions in two or more groups. Principal source: Barra, Inc., Berkeley, Calif.

COMMODITIES REVIEW

BY ERIC S. HARDY

CRB Spot indexes

CRB Futures indexes



The Commodity Research Bureau Futures Index is off more than 12% from a year ago, but that decline is modest compared with the more pronounced drops in several components of this index. The coffee and cocoa group is off 19% for the 12 months through June, the grain group off an average 17%. The sharpest decline is in the oilseed (soybeans and linseed) group, which lost 25%. Although September crude oil futures gained 8.5% over the last three months, petroleum prices stand a good chance of declining: Domestic inventories are higher than they were this time last year, and consumption remains sluggish. Even gasoline prices, which should now be experiencing peak seasonal demand, have been weak. This weakness in commodities prices has to a degree counteracted inflation in the service sector (doctor bills, for instance). The Consumer Price Index for services is up 5.4% over May 1990 while the overall Index is up 5.0% over May 1990.

C.J. Lawrence chief economist Edward Yardeni is confident that the downward trend in the commodity futures index will eventually mean a slowdown in price increases at the retail level. Yardeni expects consumer prices to rise only about 3% throughout 1991. "It is somewhat unusual to see the economy start recovering while commodity prices are still falling," adds Yardeni. "The pessimists are saying this means the recovery is only a mirage, but I believe it's legitimate because I see improving sales and declining inventories." Low prices and high output would be the best of all possible worlds.

Commodity spotlight

September corn[5] ($ per bushel)

According to a recent report from the U.S. Department of Agriculture, more corn was planted this year than was originally thought, and existing inventories are fairly high. An expected reduction in corn exports to the Soviet Union also drove down corn prices. But the market rallied somewhat with news that weather may deteriorate later this summer.

Cash and futures prices

Spot indexes

Index[6]	Value	3-mo change
All commodities	240.92	-6%
Raw industrials	280.14	-5
Metals	243.62	-8
Textiles	257.27	-2
Foodstuffs	193.61	-8

Futures indexes

Index[6]	Value	3-mo change
CRB index	206.18	-7%
Precious metals	251.84	2
Industrials	235.93	0
Grains	166.16	-10
Livestock & meat	197.82	-15

Spot commodity prices

Index	Price	3-mo change
Steel scrap (short ton)	$89.00	-9%
Copper scrap (pound)	0.82	-8
Print cloth (sq yard)	0.85	5
Corn (bushel)	2.21	-11
Soybean oil (pound)	0.18	-15

Futures prices

Index	Price	3-mo change
Oct platinum (troy oz)	$387.90	-6%
Sept crude oil (barrel)	21.17	9
Sept copper (pound)	1.01	-4
Oct cotton (pound)	0.71	-5
Sept Chi wheat (bushel)	2.64	-12

Note: All prices as of 7/9/91. [1]Composed of 13 commodities. [2]Composed of the 13 raw industrial commodities plus 10 foodstuffs. [3]Gold, platinum and silver. [4]Composed of 21 commodities. [5]Prices from 4/9/91 through 7/9/91. [6]Base for spot and futures indexes (1967=100). Source: Knight-Ridder Commodity Research Bureau.